Office of Chief Counsel
Internal Revenue Service

memorandum

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to: International Group Manager 4508 NWSAT
North Texas District

from: Todd Ludeke
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subject: [redacted]
Section 482 Issue

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I. INTRODUCTION

In [redacted] in a section 351 exchange, [redacted] transferred stock in [redacted] from [redacted] ([redacted]) [redacted] to [redacted] then sold the [redacted] stock at a loss, which it reported on its [redacted] return. This memo will address that transaction.

II. COMPANY BACKGROUND

Until [redacted] ("[redacted]) was a wholly-owned [redacted] ("[redacted]"), a Canadian Corporation. [redacted] sold its shares in [redacted] to [redacted] ("[redacted]"), effective [redacted] [redacted] is a wholly-owned [redacted]

On [redacted] [redacted] transferred all of the shares of [redacted] to [redacted] ("[redacted]"), a wholly-owned subsidiary of [redacted] In return, [redacted] received [redacted] common shares of [redacted] valued at $[redacted] On [redacted] [redacted] was liquidated and its assets, including [redacted] were transferred to [redacted]

For the fiscal years ended [redacted], [redacted] and [redacted] filed consolidated returns with its group of affiliated companies. The U.S. consolidated group consisted of the parent, [redacted] and approximately [redacted] subsidiaries. All U.S. operations were conducted through [redacted]

III. THE [redacted] STOCK ISSUE

A. History of the [redacted] stock

[redacted] began purchasing [redacted] stock, both ordinary shares and [redacted] shares), in [redacted] Through these purchases and stock dividends, [redacted] owned [redacted] shares of [redacted] stock by [redacted] According to [redacted] these purchases were made by [redacted] rather than [redacted] because [redacted] had substantial US operations and [redacted] preferred having [redacted] hold its US operations.

On [redacted] [redacted] purchased [redacted] additional shares of [redacted] from [redacted] and one of its subsidiaries. After this purchase, [redacted] continued to purchase [redacted] shares, and by [redacted], owned [redacted] shares.

In [redacted] began purchasing [redacted] ordinary stock. To fund the purchases, [redacted] transferred funds to [redacted] (Canada), which then purchased preferred shares of [redacted] and transferred the funds to [redacted] On its general ledger, [redacted] recorded loans receivable from [redacted] decreased its loan receivable from [redacted] by recording the issuance of Class A shares to [redacted]

On [redacted], [redacted] agreed to sell all of its shares in [redacted] to [redacted] for $[redacted] with payment due on [redacted] To fund the acquisition, the following steps occurred:

1. [redacted] loaned $[redacted] to [redacted] ("[redacted]")(Canada)
2. [redacted] issued Class C shares to [redacted] for $[redacted]

3. [redacted] issued Class C shares to [redacted] for $[redacted]
4. [redacted] issued class A shares to [redacted] in exchange for $[redacted] shares of [redacted] valued at $[redacted]
5. [redacted] purchased [redacted] shares of [redacted] for $[redacted]
6. [redacted] purchased [redacted]s entire shareholding in [redacted] for $[redacted]

Subsequent to the filing of its [redacted] return, [redacted] agreed that the correct fair market value of the stock sold from [redacted] to [redacted] was $[redacted] This resulted in an adjustment to income of $[redacted]

On [redacted] [redacted] transferred [redacted]% of the common stock of [redacted] to [redacted] in exchange for [redacted] shares of [redacted] The same day, [redacted] transferred [redacted] shares of [redacted] common stock to [redacted] in exchange for [redacted] shares of [redacted] stock. [redacted] filed a statement with their [redacted] tax return under Treas. Reg. § 1.351.2 stating that the transfer was a valid section 351 exchange. The statement claimed a tax basis of $[redacted] and a fair market value of $[redacted]

In response to an IDR, [redacted] stated its business purpose for the transfer of ownership of [redacted] from [redacted] to [redacted] was "to facilitate the contribution by [redacted] of its assets to [redacted]."[1] [redacted]s stated business purpose for the transfer of the [redacted] stock from [redacted] to [redacted] was "to increase the value of [redacted]s equity to support its debt raising capacity."[2]

In [redacted], [redacted] issued $[redacted] of convertible debentures that were linked to the [redacted] stock. According to [redacted] "[e]conomically [the [redacted] stock was disposed of] when the [redacted]-linked debentures were issued."[3] This was because [redacted] stock could be delivered to the convertible debenture holders. After the [redacted]-linked debentures were issued, [redacted] reported that "the monetization of [its] [redacted] investment [was] completed in [redacted]."[4]

B. [redacted] Financing

During the years at issue, [redacted] had individual lines of credit with several banks. In addition to these lines of credit, [redacted] and [redacted] entered into a credit agreement with a syndicate of banks on [redacted] The total line of credit for these agreement is $[redacted] [redacted] guaranteed the credit under this agreement, which required [redacted] to maintain certain consolidated financial ratios.

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1 Response to IDRs IE-34, 285.

2 Response to IDR IE-284.

3 Response to IDR IE-268.

4 [redacted]

During [redacted] through [redacted], almost all of [redacted]s financing was provided by [redacted] [redacted]s debt consisted of the following:

	[redacted]
Related Party Debt	$ [redacted]
Unrelated Party Debt	[redacted]
Total	$[redacted]

Of [redacted]s total financing in these years, less than ten percent was provided by unrelated parties.

C. The Sale of the [redacted] stock

On [redacted] agreed to sell [redacted] shares of [redacted] Limited to [redacted] for $[redacted] [redacted] also granted an option to [redacted] to purchase an additional [redacted] shares. [redacted] exercised this option on [redacted] and paid $[redacted] for the [redacted] stock. With these transactions, totaling [redacted] shares, [redacted] purchased [redacted]s entire holding in [redacted].[5] ([redacted] states that the [redacted] difference between the shares sold and [redacted]'s holding was an accounting error.)

[redacted] claimed a $[redacted] capital loss on the sale of the [redacted] stock as follows:

Sales Price	$ [redacted]
Cost Basis	[redacted]
Loss	$ ([redacted])

[redacted]s cost basis as reflected on the return consisted of the following:

Cost basis for [redacted] shares from [redacted]	$[redacted]
IRS Audit adjustment	[redacted]
Total Basis of section 351 transfer	$[redacted]
Cost for [redacted] shares purchased in [redacted]	[redacted]
"Cost basis" used on tax return	$[redacted]

IV. LEGAL ANALYSIS

A. The Issue

The transaction at issue, though obscured by [redacted]s byzantine corporate structure, is at its

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On [redacted], [redacted] purchased [redacted] shares of [redacted] from [redacted]. These shares were sold to [redacted] along with the shares that [redacted] transferred to [redacted] in [redacted].

heart quite simple. [redacted] began to purchase [redacted] stock. About a year later, [redacted] started purchasing the same stock. [redacted] sold its [redacted] holdings to [redacted] After the value of the [redacted] stock declined, [redacted] transferred its holdings to [redacted] ([redacted] had originally owned most of the stock it received from [redacted] in this transfer.) [redacted] reported no gain or loss on this transfer, which is claimed was a nonrecognition transfer under section 351. About a year after [redacted] received the stock from [redacted], the stock was sold to an unrelated third party. [redacted] claimed a loss on the sale in excess of $[redacted] Exam proposes allocating the loss to [redacted] under section 482.

B. Section 482

Section 482 gives the Commissioner the authority to allocate income among related taxpayers in order to clearly reflect income. Allocations under section 482 must be upheld unless the taxpayer can prove the Commissioner's determination is "arbitrary, capricious, or unreasonable." Eli Lilly & Co. v. Commissioner, 84 T.C. 996, 1131 (1985), aff'd in part, rev'd in part, 856 F.2d 855 (7th Cir. 1988). Allocations may be made under section 482 even if the transaction at issue otherwise qualifies for nonrecognition treatment under applicable provisions of the Internal Revenue Code. Treas. Reg. § 1.482-1(f)(1)(iii).

The interaction of section 482 and nonrecognition provisions of the Code has been addressed on several occasions. "National Securities Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943), aff'g, 46 B.T.A. 562 (1942) is the seminal case in which what is now section 482 was applied in the context of a section 351 transaction for the purpose of preventing the evasion or avoidance of taxes." G.D. Searle & Co. v. Commissioner, 88 T.C. 252, 360 (1987) (notes omitted). National Securities addressed the company's receipt of stock from its parent American Equitable Insurance Company of New York. The stock at issue, in Standard Gas & Electric Company, had a basis of approximately $120 per share in American's hand. After Standard filed bankruptcy its stock plunged, dropping to $6.25 per share. After the decline, American transferred 1,000 shares of Standard stock to National Security in exchange for shares in National Security valued at $8,562.50. Citing the predecessor to section 351 (sections 112(b)(5) and 113(a)(8)), American recognized no gain or loss on the transfer. National sold the standard stock for $7,175 and claimed a loss of $133,204.06, which represented the difference between the sales price and the $140,378.06 Standard basis. The Commissioner disallowed the loss in its entirety.[6]

Arguing that it was entitled to the loss, National contended that section 45 (the predecessor to section 482) could not override the specific nonrecognition provisions of the Code. The Third Circuit disagreed: "[i]n every case in which the section [45] is applied its application will necessarily result in a conflict with the literal requirement of some other provision of [the Internal Revenue Code]." National Securities, 137 F.2d at 603. Analyzing the transaction at issue, the

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The Service later conceded that the taxpayer was entitled to a loss of $1,387.50 - the difference between the market value of the National stock transferred to American and the sales price of the Standard stock.

court concluded that allowing the subsidiary to deduct a loss that properly belonged to the parent gave "an artificial picture of [the parent's] true income." Id. at 604. And the Commissioner was not required to accept National's claim that it received the stock from the parent because the stock was an unwise investment for an insurance company. Therefore, the Commissioner's allocation was not arbitrary or capricious and the section 482 adjustment was upheld.

In upholding the Commissioner's adjustment the court did not explicitly require that the disallowed transfer have tax avoidance as a motive. The court did note in passing, however, that it appeared that "[American] could not have derived any tax benefit from ... the loss...." Id. at 603, n. 3. And subsequent courts have created an explicit tax-avoidance requirement when addressing the interaction of sections 482 and the nonrecognition provisions of the code.

The most explicit development of the tax-avoidance requirement was in Ruddick Corp. v. United States, 643 F.2d 747 (Cl. Ct. 1981). There the court addressed the transfer of stock via a dividend in 1968 from Ruddco, Inc. to its parent, R.S. Dickson and Company ("RSD") (which was a wholly-owned subsidiary of Ruddick Corp.). At the time the stock was transferred Ruddco was profitable, while RSD had a large net operating loss carryforward that would expire when Ruddick was reorganized in 1970. After the transfer, in 1969, Ruddco sold the stock it received from RSD at a considerable gain. Using section 482, the Service allocated the gain to RSD. Both parties filed motions for summary judgment, agreeing, for the purpose of the motions, that at the time of the transfer no sale of the securities was contemplated and that the reorganization was not made with tax avoidance motives. Analyzing the transaction with these agreed facts in mind, the court concluded that section 482 was not intended to overturn the nonrecognition provisions of the Code:

> It should be kept in mind that the prime objective of section 482 is to enable the Service to ascertain "the true income picture" and the income which accrued during the fiscal year for the enterprise as a whole. CF. Central Cuba Sugar Co. v. United States, 198 F.2d at 215, 216. To apply section 482 on the present assumptions would be to elevate a purely technical "distortion" permitted by Congress over the economic reality that there was no distortion.

Id. at 754.

Recognizing the purpose of the nonrecognition provisions, the court concluded that section 482 could not be applied in the absence of taint, tax avoidance, or tax evasion and remanded the case for further factual findings.

On remand, interpreting the decision, the trial court established a test for determining whether a nonrecognition transfer was tainted by tax avoidance or evasion motives. Ruddick Corp. v. United States, 83-2 U.S.T.C. ¶ 9480, aff'd without published opinion, 732 F.2d 168 (Ct. Cl.

1984). Under that test, a transaction is tainted if (1) the transfer is prompted by tax rather than true business motives and (2) at the time of the transfer there was a plan to sell the transferred property. Applying the test, the court looked at Ruddick's avowed purpose for the dividend which was to increase the capital of RSD. The court found this purpose, which resulted from Ruddick's failure to properly capitalize RSD during a reorganization, flowed from tax-avoidance motives: "The repair of a financial wound that is intentionally self-inflicted is not a business purpose antithetical to garden variety tax maneuvering." Id. at 87,726. Finding that sale of the stock was contemplated prior to the transfer to RSD, the court concluded that the dividend was properly taxable to Ruddco and upheld the allocation.

The tax evasion / avoidance requirement developed in Ruddick has not always been followed. In Eli Lilly, for example, the court noted that "National Securities and subsequent law make it clear that a valid business purpose will not preclude the application of section 482 in [a case where a nonrecognition provision of the code is involved] when necessary to clearly reflect income." Eli Lilly, 84 T.C. at 1121, n. 57. But even courts that do not require a tax avoidance motive still look to that factor. Southern Bancorporation v. Commissioner, 67 T.C. 1022 (1977) (holding that a valid business purpose would not insulate the taxpayer from a section 482 adjustment but still discussing taxpayer's tax-avoidance motive). So though tax avoidance may not be a prerequisite for a section 482 adjustment, it is an important consideration. With this somewhat conflicting authority in mind, the [redacted] transaction will be examined.

D. The [redacted] Transaction

[redacted]'s transaction can be examined in light of the test set forth in Ruddick. The first step is whether the transfer is prompted by tax rather than business motives. As in most cases, [redacted]'s tax motive is clear - the ability to use a capital loss in excess of $[redacted] that would otherwise remain uselessly in the [redacted][7] And the business purpose, which [redacted] claims was to

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[7] At the time of the transfer, [redacted] had no income to offset the loss, which in any event would be far less useful in the [redacted] where the maximum tax rate on [redacted] would be [redacted] percent. Further, [redacted] had no real business operations that would ever generate any income whatsoever. In fact, about a year after the transfer of the [redacted] stock, [redacted] was liquidated and its assets transferred to [redacted].

At the time of the transfer [redacted] [redacted] had no capital gain to offset with the loss. But on [redacted], [redacted] announced that it was selling [redacted] ("[redacted]") to [redacted]; a sale which resulted in a capital gain in excess of $[redacted]. Because [redacted] has not answered IDRs pertaining to the sale of [redacted] at this time, it is unclear when negotiations to sell [redacted] began. It is clear, however, from a [redacted] report that contact with [redacted] occurred at least as early as [redacted]. In any event, even absent further proof of when the negotiations to sell [redacted] started, [redacted] has "increase the value of [redacted]s equity to support its debt-raising capacity," is not supported by the evidence. Importantly, the [redacted] stock was monetized prior to its transfer to [redacted] and therefore could not be used as collateral in any event. Furthermore, all of [redacted]s third-party debt was guaranteed by [redacted] and any financial ratios required by the lenders applied to [redacted], not [redacted] Thus the stock transfer would have no effect. Finally, [redacted]s claim that [redacted] needed to raise its debt-raising capacity is belied by the fact that [redacted]s unrelated third-party debt was only about five percent of its total debt.

In short, when the transferred stock could not be used as collateral, [redacted] guaranteed all of [redacted]s debt, and [redacted] had insignificant amounts of outside debt, [redacted]s claim that the transferred stock would increase its debt-raising capacity is not credible. The first step of the Ruddick test is met.

The second step the Ruddick court set out - whether a plan to sell the property existed at the time of the transfer - is more problematic. In Ruddick, the taxpayer had a "specific plan, articulated and recommended ... [to] utiliz[e] [the taxpayer's] loss carryover." Ruddick, 83-2 U.S.T.C. at 87,726. Here, no such specific plan existed. But [redacted] undoubtedly contemplated the sale of the stock when it was transferred.

According to [redacted], "[t]here was no potential buyer of the [redacted] shares or a third party engaged to sell the shares at the time they were contributed to [redacted] in [redacted]"[8] In its response, however, [redacted] fails to answer whether they "contact[ed]"[9] any third party. Rather, [redacted] says no third party was "engaged." In any event, [redacted]s business plan indicates that the sale of the [redacted] shares was a priority. The Balance Sheet Commentary section of the business plan states that "[t]he budget reflects the disposal of the company's interest in [redacted] ..."[10] The budget also refers to use of the sales proceeds of the [redacted] stock to reduce the debt of [redacted][11] So though no definite plan existed, the planned sale of the stock prior to the transfer date is evident.

Under the two prong Ruddick test, there is no question that a section 482 transfer is proper. And an analysis of the purpose of section 482 and the nonrecognition provisions of the code, further demonstrates that the section 482 adjustment is also proper.

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offered no compelling non-tax reason for the transfer of the [redacted] stock and there is no question that the loss could not be used in the [redacted]

[8] Response to IDR IE 268

[9] The IDR asked whether [redacted] "contact[ed]" any third party, not whether a third party was "engaged."

[10] Response to IDR IE 268.

[11] Id.

The purpose of section 482 is to clearly reflect income. G.D. Searle, 88 T.C. at 359. ("[R]espondent may make allocations under section 482 among related parties in order to prevent distortion of income."). The purpose of the nonrecognition provisions of the code is to allow taxpayers to postpone the time when gains or losses are recognized or to permit the shifting of income and expenses among related parties. Melvin S. Adess, The Role of Section 482 in Nonrecognition Transactions - The Outer Edges of Its Application, 57 Taxes 946, 948-950 (1979). To determine when section 482 should be applied "it is necessary to examine the cases in which the nonrecognition transaction was effected in a manner producing and unwarranted or impermissible income distortion." Id. at 950. Though unstated, the key to determining whether a particular income distortion in unwarranted or impermissible is whether the income distortion is permanent or temporary. See Ruddick, 643 F.3d at 757, (Kashiwa,, J., concurring in part, dissenting in part)("The total escape of this tax by any of the controlled entities is a material distortion of income and here, taint aside, the Commissioner can allocate the gain...."). In this case, making that decision requires analyzing [redacted]s position before and after the transfer.

Prior to the [redacted] stock transfer, the unrealized loss on the stock resided in the [redacted]. If realized, the loss could be used to offset nonexistent [redacted] income which even had it existed would have been taxed at a [redacted] percent rate. After the transfer, the unrealized losses' value increased substantially - not only would [redacted] soon have a gain to offset, but the applicable tax rate was now [redacted] percent. Here, the effect of the nonrecognition provision is not delaying the loss or moving it to a related entity. Rather it is to turn a previously unrealizable loss into a soon-to-be-realized benefit, which was subsequently used to offset a portion of the large gain resulting from the sale of [redacted]. This result is an unwarranted distortion of income. The allocation of the loss to [redacted] under section 482 is correct.

IV. CONCLUSION

[redacted]s transfer of the [redacted] stock was done for tax purposes. The transfer moved a useless loss from the [redacted] to the United States, which allowed [redacted] to offset a portion of its gain on the sale of [redacted]. The allocation of this loss back to the [redacted] under section 482 is correct and should be sustained.